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July 11, 2014

Kevin O'Neill
Deputy Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File No. SR-FINRA-2014-006 - Proposed Rule Change Relating to per Share Estimated Valuations for Unlisted DPP and REIT Securities – Response to Comments

Dear Mr. O'Neill:

This letter is being submitted by Financial Industry Regulatory Authority, Inc. ("FINRA") in response to comments filed with the U.S. Securities and Exchange Commission ("SEC" or "Commission") regarding the above-referenced rule filing (the "Proposal"). The Proposal would amend: (1) NASD Rule 2340 (Customer Account Statements) to modify the requirements relating to the inclusion of a per share estimated value for direct participation program ("DPP") and unlisted real estate investment trust ("REIT") securities on a customer account statement; and (2) FINRA Rule 2310 (Direct Participation Programs) to modify the requirements applicable to members' participation in a public offering of DPP or REIT securities.¹

These rules currently require, among other things, a general securities member to include on account statements an estimated value of a DPP or REIT security from the annual report, an independent valuation service or any other source, unless the member can demonstrate the estimated value is inaccurate. FINRA, however, has become increasingly concerned regarding the industry practice of using the offering price (or "par value") of DPP and REIT securities as the per share estimated value during the offering period, which can continue as long as seven and a half years. The offering price, typically \$10 per share, often remains constant on customer account statements during this period even though various costs and fees have reduced investors' capital. The Proposal seeks to address this and other important concerns.

¹ See Securities Exchange Act Release No. 71545 (February 12, 2014), 79 FR 9535 (February 19, 2014) (Notice of Filing of Proposed Rule Change; SR-FINRA-2014-006).

The SEC's first comment period on the Proposal closed on March 12, 2014.² The SEC received 18 comment letters in response to this first comment period.³ On

² *See id.*

³ *See* Letter from Mark Goldberg, Chairman, Investment Program Association, to Elizabeth M. Murphy, Secretary, SEC, dated February 5, 2014; Letter from David T. Bellaire, Esq., Executive Vice President & General Counsel, Financial Services Institute, to Elizabeth M. Murphy, Secretary, SEC, dated February 5, 2014; Letter from Mark Kosanke, President, Real Estate and Investments Securities Association, to Elizabeth M. Murphy, Secretary, SEC, dated February 11, 2014; Letter from Steven A. Wechsler, President and CEO, National Association of Real Estate Investment Trusts, to Elizabeth M. Murphy, Secretary, SEC, dated February 14, 2014; Letter from Jeff Johnson, Chief Executive Officer, Dividend Capital Diversified Property Fund Inc., to Elizabeth M. Murphy, Secretary, SEC, dated February 28, 2014 ("Dividend"); Letter from Michael Crimmins, Chief Executive Officer/Managing Director, KBS Capital Advisors LLC, to Elizabeth M. Murphy, Secretary, SEC, dated February 28, 2014 ("KBS"); Letter from Scott C. Ilgenfritz, Immediate Past-President, Public Investors Arbitration Bar Association, to Elizabeth M. Murphy, Secretary, SEC, dated March 11, 2014 ("PIABA"); Letter from Thomas F. Price, Managing Director, Securities Industry and Financial Markets Association, to Elizabeth M. Murphy, Secretary, SEC, dated March 12, 2014 ("SIFMA"); Letter from Steven Morrison, Associate Counsel, LPL Financial, to Elizabeth M. Murphy, Secretary, SEC, dated March 12, 2014 ("LPL"); Letter from Jacob Frydman, Chairman & CEO, United Realty Trust Incorporated, to Elizabeth M. Murphy, Secretary, SEC, dated March 12, 2014 ("United Realty"); Letter from Dechert LLP, to Elizabeth M. Murphy, Secretary, SEC, dated March 12, 2014 ("Dechert"); Letter from David Hirschmann, President and Chief Executive Officer, Center for Capital Markets Competitiveness, U.S. Chamber of Commerce, to Elizabeth M. Murphy, Secretary, SEC, dated March 12, 2014 ("Chamber"); Letter from Steven A. Wechsler, President & CEO, National Association of Real Estate Investment Trusts, to Elizabeth M. Murphy, Secretary, SEC, dated March 12, 2014 ("NAREIT"); Letter from Kirk A. Montgomery, Head of Regulatory Affairs, CNL Financial Group, LLC, to Elizabeth M. Murphy, Secretary, SEC, dated March 12, 2014 ("CNL"); Letter from Mark Goldberg, Chairman, Investment Program Association, to Elizabeth M. Murphy, Secretary, SEC, dated March 12, 2014 ("IPA"); Letter from David T. Bellaire, Esq., Executive Vice President & General Counsel, Financial Services Institute, to Elizabeth M. Murphy, Secretary, SEC, dated March 12, 2014 ("FSI"); Letter from Martel Day, Principal, NLR Advisory Services, to Elizabeth M. Murphy, Secretary, SEC, dated March 12, 2014 ("NLR"); Letter from Mark Kosanke, President, Real Estate Investment Securities Association, to Elizabeth M. Murphy, Secretary, SEC, dated March 12, 2014 ("REISA"). FINRA also submitted a

May 20, 2014, the SEC instituted proceedings to determine whether to approve or disapprove the Proposal and noticed a new comment period, which closed on June 26, 2014.⁴ In response to this second comment period, the SEC received five comment letters.⁵

Commenters generally supported FINRA's efforts to provide greater transparency and enhance investor protection for DPPs and REITs.⁶ However, commenters raised a number of issues regarding specific aspects of the Proposal.

This letter responds to the main issues raised by commenters. FINRA also filed today with the SEC Amendment No. 1 to SR-FINRA-2014-006, which incorporates changes proposed in response to various comments discussed below.

letter notifying the SEC that it was still reviewing the comment letters and anticipated submitting a response to comments and amendments to the Proposal. *See* Letter from Matthew E. Vitek, Assistant General Counsel, FINRA, to Kevin O'Neill, Deputy Secretary, SEC, dated May 16, 2014.

⁴ *See* Securities Exchange Act Release No. 72193 (May 20, 2014), 79 FR 30217 (May 27, 2014) (Order Instituting Proceedings To Determine Whether To Approve or Disapprove a Proposed Rule Change; SR-FINRA-2014-006).

⁵ Four of the comment letters incorporated by reference earlier comments submitted in response to the first comment period. *See* Letter from Jason Doss, President, Public Investors Arbitration Bar Association, to Elizabeth M. Murphy, Secretary, SEC, dated June 25, 2014; Letter from Mark Kosanke, President, Real Estate Investment Securities Association, to Elizabeth M. Murphy, SEC, dated June 26, 2014; Letter from Thomas F. Price, Managing Director, Operations, Technology & BCP, Securities Industry and Financial Markets Association, to Elizabeth M. Murphy, Secretary, SEC, dated June 26, 2014; David T. Bellaire, Esq., Executive Vice President & General Counsel, Financial Services Institute, to Elizabeth M. Murphy, Secretary, SEC, dated June 26, 2014. FINRA does not separately address these comment letters herein because they do not raise new issues. The SEC also received a new comment letter from an individual investor of a REIT security, which FINRA addresses. *See* Letter from Kenneth Mills, to Elizabeth M. Murphy, Secretary, SEC, dated June 24, 2014 ("Mills"). FINRA submitted a letter reiterating its intent to file a response to comments and amendments to the Proposal. *See* Letter from James S. Wrona, Vice President and Associate General Counsel, FINRA, to Kevin O'Neill, Deputy Secretary, SEC, dated June 19, 2014.

⁶ Chamber, CNL, Dechert, Dividend, FSI, IPA, KBS, LPL, Mills, NAREIT, SIFMA and United Realty.

“Not Priced” Option of Per Share Estimated Value

The Proposal would make voluntary, rather than mandatory, the requirement in Rule 2340(c) that general securities members include the per share estimated value that is reflected on a DPP or REIT security's annual report. Under the Proposal, a member may include in a customer account statement a per share estimated value only if: (1) the value was developed in a manner reasonably designed to ensure that it was reliable; (2) the member had no reason to believe that it was unreliable; and (3) the account statement included certain disclosures. The Proposal provides two methodologies under which an estimated value would have been presumed reliable, one called the “net investment methodology” that reflects various commissions and expenses and that could be used for two years, and the other being an appraised valuation.

A number of commenters did not support the proposed elimination of the mandatory requirement to provide an estimated value on account statements.⁷ Some commenters asserted the “not priced” option would cause an immediate write-down of customer net worth, confuse investors and impair effective asset allocation and tax planning.⁸ Commenters also stated that allowing a DPP or REIT security to be shown as “not priced” would deprive investors of useful information and would decrease investor transparency.⁹ In addition, a few commenters claimed the “not priced” option would impact broker-dealer and custodian compliance with Internal Revenue Service (“IRS”) reporting.¹⁰ According to this claim, the “not priced” option may result in individual retirement accounts custodians or trustees no longer supporting DPPs and REITs due to the obligation to provide fair market value information to end-customers and the IRS.¹¹ Finally, one commenter suggested that firms have no incentive to report a per share estimated value that is less than the cost basis of each share.¹²

The commenters that opposed optional disclosure also pointed out that FINRA proposed two methodologies that will be presumed to have been developed in a manner reasonably designed to ensure that the per share estimated value is reliable.¹³

⁷ FSI, IPA, LPL, NLR, PIABA, REISA and SIFMA.

⁸ FSI and IPA.

⁹ IPA, LPL and NLR.

¹⁰ IPA and SIFMA.

¹¹ SIFMA.

¹² PIABA.

¹³ IPA, NLR and REISA.

One recommended, however, that members be required to report appraised values based upon an independent appraisal.¹⁴

The comments, including those submitted by member firms, demonstrate a commitment to improving disclosure and transparency regarding fees and expenses and share values for these illiquid investments. The vast majority of commenters clearly believe that investors will benefit by receiving values on their account statements that are calculated according to the two methodologies provided in the Proposal. After analyzing the comments, FINRA agrees that showing the securities on account statements as “not priced” may be confusing to investors and does not fully promote transparency. Accordingly, FINRA is amending the Proposal to require general securities members to include in customer account statements a per share estimated value for a DPP or REIT security. Under this amendment, a general securities member would be required to include in a customer account statement a per share estimated value of a DPP or REIT security, developed in a manner reasonably designed to ensure that the per share estimated value is reliable. Moreover, the per share estimated value will be deemed to have been developed in a manner reasonably designed to ensure that it is reliable if the member uses one of the two specified methodologies.

Reliability of Per Share Estimated Value

As noted above, the Proposal would amend Rule 2340 to provide that any member may include a per share estimated value of a DPP or REIT security on a customer account statement, provided that such value has been developed in a manner reasonably designed to ensure that it is reliable, the member has no reason to believe that the per share estimated value is unreliable, and the account statement provides disclosures set forth in the rule. Several commenters had concerns with the “no reason to believe that the per share estimated value is unreliable” standard.¹⁵

A number of commenters asserted that such a standard was unclear, would raise litigation issues, or would require clearing firms “to continuously monitor the ‘reliability’ of estimated pricing received for millions of introduced accounts to determine if they had ‘no reason to believe’ the information was unreliable.”¹⁶ One commenter recommended changing the standard to permit disclosure of a valuation unless the member has reason to believe that such per share estimated value is unreliable.¹⁷

¹⁴ PIABA.

¹⁵ IPA, KBS, LPL, NLR and SIFMA.

¹⁶ SIFMA; *see also* KBS, IPA and LPL.

¹⁷ SIFMA.

In response to the commenters' concerns, FINRA is amending the Proposal by eliminating the "no reason to believe that the per share estimated value is unreliable" standard. FINRA recognizes that DPP and REIT securities are illiquid and no valuation is perfect. However, the Proposal as amended would require disclosure of valuations and would deem valuations calculated under the two defined methodologies in the Proposal to have been developed in a manner reasonably designed to ensure that they are reliable. As a result, the standard that was originally proposed is not necessary. If with experience FINRA determines that a more reliable valuation could be developed under another methodology, FINRA will consider recommending further amendments to the rule.

Net Investment Methodology

The "net investment" methodology would deduct from the gross offering price issuer offering and organizational ("O&O") expenses, commissions and dealer manager fees. This value is reflected in the "amount available for investment" percentage in the "Estimated Use of Proceeds" section that is included in most DPP and all REIT offering prospectuses.¹⁸ The "Estimated Use of Proceeds" section, however, does not include a deduction for "over distributions." "Over distributions" are common during the offering period before acquired assets generate significant revenues and essentially represent return of investors' capital.¹⁹ Under the Proposal, the net investment methodology also would deduct "over distributions" from the per share estimated value using a fairly complex formula.

Commenters did not raise substantive issues with the Proposal's requirement that the net investment methodology deduct commissions and dealer manager fees. A number of commenters, however, raised issues with the Proposal's requirement that the net investment methodology deduct O&O expenses and over distributions. Each is discussed below.²⁰

¹⁸ The "amount available for investment" is typically included in the prospectus for REIT offerings and is described in the Securities Act of 1933 ("Securities Act") Industry Guide 5 (Preparation of registration statements relating to interests in real estate limited partnerships). Where "amount available for investment" is not listed in the prospectus, an equivalent disclosure in the "Estimated Use of Proceeds" section may be used.

¹⁹ The Proposal states that "over distributions" constitute the portion of cumulative distributions per share that exceeded GAAP net income per share for the corresponding period, after adding back depreciation and amortization or depletion expenses.

²⁰ In addition to issues with O&O expenses and over distributions, one commenter indicated concern over timing aspects of the net investment methodology, particularly with regard to when members could no longer use it

O&O Expenses

A number of commenters had concerns with deducting O&O expenses from the per share estimated value.²¹ The main concern was that O&O expenses are indeterminate at the outset of an offering.²² In addition, one commenter asserted that because the cost of performing due diligence is included in O&O expenses, issuers may be unwilling to reimburse firms for such expenses.²³ Moreover, a few commenters stated that the deduction of O&O expenses is inconsistent with account statement reporting requirements for other asset classes.²⁴ Four commenters recommended that “net investment” be defined as gross offering proceeds reduced by commissions and dealer management fees only.²⁵

If FINRA determines to deduct O&O expenses, two commenters requested that FINRA clarify that the percentage in the “Estimated Use of Proceeds” section should be based on the maximum number of shares to be sold in the offering.²⁶ One of these commenters believed that “using the minimum number would grossly overstate the burden of organization expenses on share values.”²⁷

FINRA continues to believe that the net investment methodology should deduct O&O expenses. While any value of an illiquid security is an estimate, netting out O&O expenses is likely to be a closer approximation to the intrinsic value, particularly since the up-front fees and expenses reduce the amount of the investable capital during the ramp-up period when the assets are acquired by the DPP or REIT.

and would be required to provide an appraised value. *See* IPA. In response, FINRA is amending the Proposal to allow for “net investment” to be included on customer account statements at any time before 150 days following the second anniversary of breaking escrow. “Net investment” will be readily discernable during this period because it is based on the “Estimated Use of Proceeds” section in the prospectus, which must be effective before the first sale of securities.

²¹ Chamber, CNL, FSI, IPA, NLR and REISA.

²² Chamber, CNL, FSI, IPA and REISA.

²³ REISA.

²⁴ CNL and NLR.

²⁵ CNL, FSI, IPA and NLR.

²⁶ CNL and KBS.

²⁷ KBS.

Requiring net values that deduct O&O expenses on customer account statements during the initial offering period will provide greater transparency to investors about fees and expenses, which would benefit investors. FINRA emphasizes, moreover, that O&O expenses are already clearly identified in issuer prospectuses and therefore subtracting them from the per share value should not be particularly difficult.

With regard to whether members may use the maximum offering percentage, FINRA recognizes that most offerings do not reach the maximum, but most raise considerably more than the minimum. Accordingly, FINRA is amending the Proposal to permit use of the maximum offering amount to calculate O&O expenses. This approach often will result in deduction of a lower percentage of O&O expenses. However, the amendment to the Proposal would not permit use of the maximum offering amount if the member has reason to believe that calculation of the O&O expenses based on the maximum is unreliable, in which case the member must use the minimum offering amount.

“Over Distributions”

Several commenters opposed the net investment methodology’s deduction of “over distributions” from the share value.²⁸ The commenters explained the complexity and impracticality of defining “over distribution” for a variety of programs, and the benefit of requiring deduction for “over distributions” does not appear to be worth the burdens of doing so.²⁹ The primary concern with “over distributions” comes from investor confusion over whether a distribution constitutes income or return of capital. With this in mind, and in light of the points commenters raised, FINRA is amending the Proposal to replace the requirement to deduct “over distributions” from the per share estimated value with enhanced disclosure relating to the return of investors’ capital. Accordingly, the amended Proposal would require account statements that provide a “net investment” per share estimated value for a DPP or REIT security to disclose, if applicable, prominently and in proximity to disclosure of distributions and the per share estimated value the following: “IMPORTANT – Part of your distribution includes a return of capital. Any distribution that represents a return of capital reduces the estimated per share value shown on your account statement.” FINRA believes that such disclosure is necessary to address misunderstanding by customers when their capital is returned to them through a distribution that otherwise appears to represent earnings on their investment.³⁰

²⁸ CNL, FSI, IPA, KBS, NLR and REISA.

²⁹ CNL, FSI, IPA, KBS, NLR and REISA.

³⁰ In addition, IPA and NAREIT asked for clarifications regarding the “over distribution” calculation. In light of the elimination of the “over distribution” calculation, no response to this comment is necessary.

Timing, Frequency and Methodology of Per Share Estimated Valuations

The Proposal amends Rule 2310(b)(5) (Valuation for Customer Account Statements) to provide that a member may not participate in a public offering of a DPP or REIT security unless a per share estimated value is calculated on a periodic basis in accordance with a methodology disclosed in the prospectus, or the general partner or sponsor has agreed to, among other things, disclose in the first report filed pursuant to Section 13(a) or 15(d) of the Exchange Act after the second anniversary of breaking escrow and in each annual report thereafter, a per share estimated value calculated by, or with the material assistance of, a third-party valuation expert and ensure that the valuation is conducted at least once every two years.

One commenter recommended that “FINRA adopt the timing provision in the IPA REIT Valuation Guideline which calls for disclosure no more than 150 days after the second anniversary of escrow break.”³¹ The commenter believed this change is necessary because of timing issues that arise when the second anniversary of breaking of escrow occurs close to the deadline for filing the periodic report.³² A number of commenters supported requiring more frequent independent appraisals after this period to further increase transparency,³³ with one suggesting “that annual valuations provide vital information to investors regarding the ongoing performance of the investment and the estimated value in the event of a sale or redemption of the security, and are helpful to ERISA trustees in complying with IRS requirements relating to ERISA account reporting.”³⁴

FINRA is mindful of the timing issues presented when the second anniversary of breaking of escrow occurs close to the deadline for filing the periodic report. Therefore, in response to the commenters’ concern, FINRA is amending the Proposal to require disclosure in a periodic or current report filed pursuant to Section 13(a) or 15(d) of the Exchange Act within 150 days following the second anniversary of breaking escrow. In addition, FINRA agrees with the commenters that more frequent valuations benefit investors and is amending the Proposal to require that the per share estimated value be based on valuations of the assets and liabilities of the DPP or REIT performed at least annually, by, or with the material assistance or confirmation of, a third-party valuation expert or service.

³¹ IPA.

³² *Id.*

³³ IPA, FSI and PIABA.

³⁴ IPA.

Business Development Companies (“BDCs”)

Three commenters raised concerns on the application of the Proposal to BDCs due to the fact that BDCs are already subject to an existing regulatory framework under the 1940 Act and the rules and regulations thereunder for determining and publishing net asset value on a regular basis.³⁵ One commenter believed that the Proposal is unnecessary for BDCs and requested that “any amendments to NASD Rule 2340 and FINRA Rule 2310 expressly direct that the NAV reported by BDCs in their most recent quarterly or annual report be included on periodic account statements to customers and that such valuation be deemed to be conclusively reliable for purposes of such rules.”³⁶ Another requested that FINRA amend the Proposal to acknowledge “that this established framework under the 1940 Act for determining and publishing net asset value on a regular basis results in a presumptively reliable valuation of BDC DPPs for disclosure by FINRA member firms on customer account statements in lieu of a Public Offering Price or Net Investment amount during the offering period and thereafter.”³⁷ Yet another expressed concern with the distinction between the “independent valuation” methodology under the Proposal and the requirements for unlisted BDCs under the 1940 Act.³⁸ This commenter noted that “the 1940 Act does not require the use of third-party valuation firms or pricing services in connection with quarterly valuations.”³⁹ Therefore, the commenter believed that the Proposal “would introduce uncertainty to the industry” and recommended that firms be “permitted to use the published NAV of an unlisted BDC on customer account statements.”⁴⁰

FINRA recognizes that BDCs that fall under the definition of DPPs are subject to an existing regulatory framework under the 1940 Act for determining and publishing net asset value on a regular basis. Therefore, FINRA is amending the Proposal to specifically except DPPs that are subject to the 1940 Act from the requirements under Rule 2310(b)(5) that a member may not participate in a DPP or REIT offering unless the issuer will disclose a per share estimated value in its annual report. In addition, the Proposal will state in the case of DPPs subject to the 1940 Act, the independent valuation methodology under Rule 2340(c)(1)(B) shall be consistent with the valuation requirements of the 1940 Act and the rules thereunder.

³⁵ CNL, Dechert and IPA.

³⁶ Dechert.

³⁷ IPA.

³⁸ CNL.

³⁹ *Id.*

⁴⁰ *Id.*

Economic Impact Analysis

Two commenters expressed concern that FINRA did not conduct a more detailed economic analysis in connection with the Proposal.⁴¹ One commenter “urged the Commission to remand [the] rule back to FINRA for economic analysis before approving the Proposed Rule Change.”⁴² The other requested that FINRA address this deficiency by either extending the implementation date of the Proposal to 18 months or conducting a thorough cost-benefit analysis.⁴³ FINRA provides additional economic analysis of the Proposal below, with a particular focus on the economic analysis as it relates to the amendments to the Proposal.

As discussed above, in the existing version of Rule 2340, customer account statements can potentially reflect the gross offering price, which is typically \$10 per share, for up to seven and a half years, after which, the general securities member must include the estimated value from the annual report in the customer account statement or an estimated value from an independent valuation service or any other source, in the first account statement issued by the general securities member thereafter.⁴⁴ Under the amended Proposal, members would be required to provide valuations no later than 150 days after the second anniversary of breaking escrow. This would represent a significantly shorter time for an appraisal over what has been permitted under the current rules.

The amended Proposal is intended to reinforce investor protection with respect to DPP and REIT securities by enhancing disclosure requirements in customer account statements. This information will make it clearer to DPP and REIT securities holders that certain commissions, fees and expenses have diminished the portfolio value. Investors will have a fairer representation of value of the investment, although marketers might have more difficulty representing the investment as retaining a “stable value” in the early years of the program.

⁴¹ Chamber and IPA.

⁴² Chamber.

⁴³ IPA.

⁴⁴ Under current industry practice, members may include an appraised value on customer account statements approximately 18 months after the completion of the offering. If the offering period lasted for the three years permitted by Securities Act Rule 415, then the first valuation may be provided approximately four and a half years after the commencement of the offering. If the member reregistered for a second three year offering period, the maximum length of the offering permitted by Securities Act Rule 415, the member could provide the first valuation approximately seven and a half years after the commencement of the offering.

The impact of these changes on the demand for these products may be twofold: First, investors will now see the direct impact of certain costs associated with investment, as these costs are deducted from the estimated per share valuation, which might cause a short-run decrease in the demand as investors anticipate lower future returns. This impact assumes that investors may not currently recognize the size or impact of the fees or the timing of fee charges. Since the demand for this product is also sensitive to expected risk-return profiles of alternatives such as publicly listed REITs, substitution effects might create a shift towards listed alternatives.⁴⁵ However, as overall expenses of DPPs and REITs are anticipated to diminish over time due to competitive forces (as discussed below), demand is expected to recover in the long-run. Moreover, the positive effect of transparency on market quality may bolster the attractiveness of these securities relative to alternatives that do not provide such transparency.

In the amended Proposal, members will be required to include an appraised value no later than 150 days following the second anniversary of breaking escrow. This requirement might impose a cost on issuers to obtain appraised values for a longer period of time during the life of a DPP or REIT program. Based on FINRA's communication with one of the major providers of independent real estate appraisal services, we understand that the annual cost of an appraisal can vary significantly depending on the nature and size of the program. Initially, the annual cost for a smaller program with similar assets is estimated to be between \$15,000 and \$90,000. However, a large, diversified global REIT, for example, may incur costs that could potentially reach \$400,000. Factors that can increase the cost of appraisal include the number of assets that must be valued, the size and complexity of those assets (*e.g.*, a motel as compared to a resort property) and the geographic location of the assets. While appraisal costs will rise as the size of the portfolio increases, due to the potential discount that may be received in some portfolios, the incremental costs may not be linear and might decrease with each additional property or other asset that is added.

According to the data shared with FINRA by the provider of independent real estate appraisal services, there were 118 newly effective programs between 2002 and 2013, with an annual high of 16 newly effective programs in 2013. As such, we develop our economic impact analysis relying on historical evidence and assuming 16 as the expected number of newly effective programs per year.

Applying historical averages on the size of DPP and REIT programs and their typical selling channels to data, approximately five of these programs are sold through broker-dealers who already impose a contractual requirement on the programs to provide independent appraisal within two years of breaking escrow, and thus would not be impacted by the proposed valuation requirements in this rule. For the 11 other

⁴⁵ Cf. Murray Carlson, Sheridan Titman and Cristian Tiu, 2010, "The Returns of Private and Public Real Estate," working paper, *available at* <http://www.prea.org/research/reri/TheReturnsOfPrivateandPublicRealEstate.pdf>.

programs sold through broker-dealers without the contractual requirement – and thus impacted by the valuation requirements of the amended Proposal – on average, approximately three programs already choose to voluntarily acquire valuation services, presumably due to the incentives to follow best practices. Therefore, we estimate, on average, approximately eight programs would incur costs associated with providing investors with independent valuation as provided in the amended Proposal. These firms would be required to provide valuation for, on average, three additional years, an assumption based on the current rule requirements and the typical length of time that programs have taken to complete their offerings.

In light of the assumptions discussed above, FINRA understands the incremental cost of valuation to small programs – defined as those raising less than \$200 million – for an additional three years to be approximately \$150,000. For larger programs – defined as those raising more than \$1 billion – FINRA understands the incremental three-year cost to be as high as \$1 million.⁴⁶ Therefore, the aggregate impact of the rule is expected to be less than \$3 million to the industry, which manages more than \$20 billion in DPP and REIT programs.

The incremental cost of purchasing valuation services imposed by the rule will be mitigated to a large extent by the fact that many program sponsors have already implemented valuation schedules that are significantly ahead of the maximum seven and a half years permitted under the current rule. FINRA's communication with the industry indicates that many programs are completing appraisals during or after the initial offering and that the market environment requires that any follow-on offering will be priced based on an appraisal. Therefore, while some programs would have to purchase appraisal services annually for up to an additional five years under the new rule, such incremental costs would not be imposed by the new rule on all programs as the industry for the most part has moved away from delaying the appraisal for over seven years.

In addition to the costs associated with generating the valuation, FINRA anticipates that the amended Proposal will increase the costs of providing the disclosures required by the rule. The costs of disclosure entail those associated with updating disclosure documents. Many of these costs are one-time costs associated with developing an updated disclosure template. Expanded disclosures may also impose greater costs for mail and distribution, to the extent that distribution is not electronic.

FINRA recognizes that these independent valuations may be imperfect, in part, because of the inherent difficulty in valuing illiquid assets such as real estate or oil and

⁴⁶ These estimates reflect the fact that the cost of the appraisal is a function of the factors described above, including the number of properties, complexity of the property and the geographic location. FINRA relies on assumptions shared by the independent provider of real estate appraisal services on the likely size of invested assets over the three-year period.

gas holdings. The presentation of independent valuations may lead to a concern of “false precision,” that is, the comparison of point estimates across different programs might lead to a misimpression that the valuations and performances of the portfolios are significantly different, whereas the difference might be largely attributed to different methodology and underlying assumptions. The valuation estimates may be sensitive to the assumptions of the methodology chosen. However, these costs are not specific to DPP and REIT securities only; rather they apply to the valuation of any unlisted, non-traded security. Further, these independent valuations still provide substantially more information to investors than does the gross offering price.

These disclosure requirements can potentially put these securities at a competitive disadvantage, if there are no such or less strict requirements on similar investment products, and if investors misinterpret the difference between the per share valuation and the gross offering amount in their investment decision. However, pricing information is generally available for unlisted securities; *e.g.*, banks provide quotes on unlisted structured products for which valuation is similarly challenging and rely on the assumptions of the method chosen. Therefore, the amended Proposal is not expected to have a negative effect on competition.

Investors should benefit from earlier access to the more relevant information regarding the fair value of the underlying portfolio. The requirement that the “net investment” approach reflect the sales commissions, dealer manager fees and O&O expenses might produce estimates that represent the true economic values of the underlying portfolios. Investors are expected to benefit from the increased transparency on the costs of the programs, and thus base their decisions using a larger information set. In addition, the increased transparency may increase competition, thereby lowering commissions, a situation observed in the past for other investment products as a result of stricter disclosure requirements.⁴⁷ This information should also help member firms to assess the suitability of the DPP and REIT securities for their clients.

Moreover, disclosing the per share value of the security at the gross offering price of \$10 creates an illusion that there is no volatility in the value of the portfolio, which is misleading due to the fact that commissions and other expenses paid by the program on the one hand, or increases in the value of the assets on the other, might cause significant deviations from the gross offering price.

Independent valuation creates useful information to assess the performance of the portfolio, provided that the value can be reliably estimated. The amended Proposal will provide flexibility around the disclosure of the valuation and the valuation method. Members can choose between the “net investment” methodology, which may be used at any time before 150 days following the second anniversary of breaking

⁴⁷ See, *e.g.*, “Investors Get a Break, as Fees For Managing Funds Are Falling” by Tom Lauricella, WALL STREET JOURNAL, April 4, 2005.

escrow, and the independent valuation methodology, which may be used at any time, or any other methodology that satisfies the criteria under Rule 2340. This flexibility not only provides valuable options to member firms, but also creates an opportunity for more accurate valuation of assets, as one method might be preferred over the other during different stages of the DPP or REIT program (e.g., the “net investment” methodology might produce more accurate estimates, and hence might be preferred, during the earlier stages of the program where the portfolio is still being built).

FINRA considered several alternatives as part of the development of the Proposal. FINRA requested public comment in two *Regulatory Notices*.⁴⁸ In *Notice 11-44*, FINRA proposed several modifications to NASD Rule 2340 that were designed to improve the quality of the information provided to customers on account statements. The amendments proposed in *Notice 11-44* would have limited the period of time during which per share estimated values could be based on the gross offering price to the initial three-year offering period provided for under Rule 415(a)(5) of the Securities Act. These amendments also would have required firms to deduct O&O expenses from the gross offering price to arrive at a per share estimated value (i.e., a net offering price). In addition, these amendments would have prohibited a firm from using a per share estimated value from any source, if it “knows or has reason to know the value is unreliable,” based upon publicly available information or nonpublic information that came to the firm’s attention. Finally, *Notice 11-44* sought to permit members to refrain from providing a per share estimated value on a customer account statement if the most recent annual report of the DPP or REIT did not contain a value that complied with the disclosure requirements of Rule 2340.

FINRA considered the comments received in response to *Notice 11-44* and issued *Notice 12-14* reflecting changes that were responsive to the comments received. Under the revised proposal in *Notice 12-14*, general securities members would no longer be required to provide a per share estimated value, unless and until the issuer provided an estimate based on an appraisal of assets and liabilities in a periodic or current report. During the initial offering period, member firms would have the option of using a modified net offering price or designating the securities as “not priced.” The revised proposal also modified the account statement disclosures that accompany per share estimated values. *Notice 12-14* also included alternative disclosure requirements for DPPs or REITs that calculate a daily net asset value.

FINRA incorporated feedback received in response to *Notice 12-14* and developed the Proposal. The Proposal allowed, but did not require, members to refrain from providing a per share estimated value on the customer account statement. In addition, the Proposal permits flexibility in choosing a methodology for developing an independent valuation and accommodates any DPP or REIT that provides a per share estimated value reflecting a valuation disclosed in the issuer report where a

⁴⁸ See *Regulatory Notice 11-44* (September 2011) (“*Notice 11-44*”) and *Regulatory Notice 12-14* (March 2012) (“*Notice 12-14*”).

third-party valuation expert or experts determine, or provide material assistance in the process of determining, the valuation.

FINRA considered the comments received in response to the Proposal and is filing an amendment to the Proposal in light of those comments. First, FINRA is amending the Proposal to require general securities members to include in customer account statements a per share estimated value for a DPP or REIT security. Second, FINRA is amending the Proposal to eliminate the “no reason to believe that the per share estimated value is unreliable” standard from the general provision in Rule 2340(c). Third, FINRA is amending the Proposal by removing the “over distribution” deduction from the per share estimated value in the “net investment” methodology and replacing it with a disclosure requirement that explains “over distributions” on the customer account statement. Fourth, FINRA is amending the Proposal to require an appraisal annually instead of every two years. Finally, FINRA is amending the Proposal to create an exception for DPPs that are subject to the 1940 Act.

In sum, FINRA has analyzed proposed changes to Rules 2340 and 2310 to increase investor protection for more than three years, has assessed the potential economic impact of those changes, and has been responsive to commenters’ concerns. The Proposal, as amended, will provide needed investor protection and will not result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act.

Effective Date

The Proposal stated that the effective date will be no earlier than 180 days following Commission approval. A number of commenters believed that additional time is necessary to limit the impact on current offerings and allow for adjustments to be made to product structures going forward.⁴⁹ In addition, several commenters recommended a longer implementation period in order to educate investors and make any necessary operational changes to comply with the Proposal.⁵⁰ Six commenters believed there should be at least an 18 month implementation period for the Proposal.⁵¹

FINRA is mindful of the commenters concerns and, as a result, is proposing to extend the effective date to no earlier than 18 months following Commission approval. FINRA believes this extended timeframe will give industry participants time to make adjustments to product structures and any necessary operational changes. In addition,

⁴⁹ CNL, FSI, IPA, KBS, NLR and REISA.

⁵⁰ CNL, LPL and NAREIT.

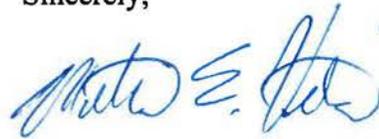
⁵¹ FSI, IPA, KBS, LPL, NLR and REISA. In addition, CNL believed that the implementation date for the Proposal should be December 31, 2015, while NAREIT requested the implementation date occur *after* December 31, 2015.

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the extended effective date will limit the impact of the Proposal on current offerings and provide firms' additional time to educate investors.

FINRA believes that the foregoing fully responds to the issues raised by the commenters. We urge the Commission to approve the Proposal, as amended. If you have any questions, please contact me at (202) 728-8156 or James S. Wrona, Vice President and Associate General Counsel, at (202) 728-8270.

Sincerely,



Matthew E. Vitek
Associate General Counsel